



# Long Island Business NEWS

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James Brennan

## Earn-outs focus on valuing a company based on future profits

By STEWART AIN

The economic downturn, combined with a continuing shrinkage in bank lending, has led to innovative methods of buying and selling a business. In the past when money was tight, the buyer and seller might agree on a price and the buyer would pay it over a period of years. But now with buyers and sellers often finding it difficult to agree on the value of the business, a new approach is being used called the earn-out.



Ira Halperin

This involves setting a price for the business based upon future profit over a set period of time, such as the first three years after the sale. "It's similar to a note, but it's not fixed," explained Ira Halperin, head of the corporate department at Meltzer, Lippe, Goldstein and Breitstone in Mineola. "The good point is that it avoids trying to determine the purchase price if the value of the business can't be determined," he said. "The buyer has some risk because he may pay more in the long run. But that is a good thing because it means his business is earning more than originally thought."

Gary Pokrassa, chief financial officer of Lakeland Industries Inc., in Ronkonkoma said that when his company was unable to agree on a purchase price for a company in Brazil two years ago, it used an earn-out. "It was a startup company and had operating losses," he recalled. "The sellers came to us with wonderful projections and we said we can't set a price based on projections. So we agreed on a down payment, and when we closed in May of '08 we agreed that the final purchase price would be based on a

## How to buy a biz when there's no agreement on price

multiple of earnings as defined." Lakeland Industries, a public company, disclosed this month that two of the three principals of the company who had signed four year employment agreements have been terminated for cause. And it said unforeseen pre-existing problems wiped out an escrow account that had been set up for such a contingency. "We'd be up the creek if we had gone with a straightforward purchase," Pokrassa said.

According to Halperin, the negative aspect of earn-outs for the seller is that he is selling his business without knowing what he will get for it. "So he is gambling because he has no control" over how the buyer will run the operation, Halperin said. That is why lawyers for the seller will often seek to include several clauses in the sales contract to limit what the buyer can do with the business that might hurt profitability. For instance, Halperin said, if a buyer wants to immediately invest in capital improvements, "that might be worthwhile over a 10- year period but it is a big expense coming at one time and it would hurt profits initially." Similarly, the seller's lawyer would want to protect against a buyer who wants to change the nature of the business that might bring him long-term gains but diminished short-term profits while the business grew. Yet another way to structure a purchase if the buyer and seller can't agree on the business's value is to have the buyer agree to pay the seller a bonus if sales, revenue or profits hit a certain figure.

"I did one based on net new clients that were brought to the table," said James Brennan, CEO and head coach of VirtualCDO, a Great River company that delivers corporate development officer and M&A advisory services. He said because buyers are concerned about the transition period between owners, "commonly there is a 90-day window of transition, depending upon the age of the seller." But some sellers who have no urge to immediately leave "will stay for a one to three-year transition period" and draw a salary, Brennan said. In that way, they are able to keep their finger on the pulse of the business and make sure it runs efficiently. "In most cases, a seller would like to tie the timeframe of an earn-out period to the timeframe of an employment period," he said. "So if you sell your business with a three-year earn-out, you would want a three-year employment agreement. And as the former owner, you are more likely to hit your earn-out targets." Another thing for the seller to consider in structuring an earn-out is how the money is to be taxed. "If you sell your business, a chunk of it is taxed at the capital gains rate, which is now 15 percent and is potentially going higher next year," Brennan said. "If you are paid a base salary while you work there, plus bonus pay, you are taxed at 30 or 40 percent. So sellers always want their income to be based on the sale of the business and not necessarily the employment."

In cases where there is no disagreement over the sale price and the buyer is unable to finance the transaction, the seller will hold a note in which the buyer promises to pay off the balance each month. In addition, the seller would also hold onto the stock of the business, not transferring it until the final payment is made. "And there are personal guarantees to make sure the buyer will pay," Brennan said. In purchases by large, publicly traded companies, he added, the difference between what the seller wants and the buyer is willing to pay is sometimes bridged with the publicly traded company's stock, provided shareholders agree.

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